

INTRODUCTION

After facing a period of severe revenue shortfalls, Montana is seeing a dramatic turnaround in some key revenue sources. Revenues from individual income, corporate income, and oil and gas production taxes have increased significantly in FY 2004, FY 2005, and FY 2006. The legislature will start the 2007 session with a large projected fund balance as of the end of FY 2009. But the fund balance is not necessarily what it appears to be, as a significant portion is from nonrecurring revenue. There are also tenuous assumptions for the capital gains component of individual income tax, the sustainability of corporate profits, and the future of oil and gas price and production. This means there is risk in using these revenues for on-going programs or services, which could create a fiscal crisis in subsequent biennia. In what is always a challenging fiscal environment, the 60th Legislature will be faced with an opportunity to shape a budget that addresses some of the state's on-going fiscal issues while at the same time taking on some very daunting fiscal challenges, including unfunded liabilities in state retirement systems, population growth in corrections, school funding, healthcare issues, and a significant building maintenance backlog.

In this chapter, we "set the stage" for the discussions to follow in these pages and during the session. It includes a state economic overview, and how those economic conditions affect the state fiscal outlook, state revenues, and the general fund budget in particular. We then summarize the major fiscal challenges this legislature faces, the executive response/solutions to the challenges, as well as issues regarding those challenges/solutions.

In a nutshell, this section provides summary answers to the following questions:

- o What is the current economic profile of Montana?
- o What is the state's fiscal condition?
- o What are the major fiscal challenges facing the 2007 Legislature?
 - What are the executive solutions to the major challenges?
 - o What are the significant issues identified by the LFD analysis?

The majority of the issues discussed in this overview are discussed in more detail in the remaining chapters.



ECONOMIC OVERVIEW

Montana state government, like any other business, is influenced by economic and demographic developments. For example, Montana's economic base as well as the strength of the U.S. economy determines the level of revenues collected from individual and corporate income taxes, property taxes, natural resource taxes, and investment earnings. Similarly, both economic and demographic conditions affect state government disbursements for education, human services, public safety, and other governmental services.

Montana's total revenue base is comprised of a number of taxes and fees plus numerous federal reimbursements or grants. Revenues are further enhanced from the investment of trust monies and idle cash pending disbursement from the state treasury. Since individual income tax is the state's largest general fund tax source, economic developments or trends in the areas of employment and income levels significantly influence available revenues to fund governmental services. Federal revenue correspondingly is used to fund a number of human service, transportation, and educational services. In a number of instances, general or state special revenue fund dollars are required to provide a state match before the federal funds can be disbursed.

Conversely, Montana's total expenditure base is targeted toward educational and human service programs, with a significant allocation to highway construction. Education and human service costs are driven by some of the same economic and demographic conditions that influence state revenues. If employment levels increase, this usually translates to an increase in population or a reduction in unemployment levels. With population increases comes a corresponding increase in educational and human service costs. A greater population requires a better transportation system, not only for the general populace, but also for the businesses that expect to expand to meet the needs of an evergrowing population.

Montana's economy is highly dependent on agriculture, tourism, natural resource extraction, and mining. All of these industries produce residual wholesale/retail trade and service sector jobs. If the basic industries are not flourishing, other sectors suffer as well. And if Montana's economy slows, tax revenue growth usually follows the trend because of the state's dependence on individual income tax revenues.

In some instances, economic strength can be a "good news / bad news" dilemma. For example, if total personal income increases significantly, this usually translates into higher individual income taxes. On the disbursement side, however, strong personal income growth can result in increased state general fund match amounts for the federal Medicaid program. If Montana's total personal income growth is unusually high when compared to the national average, the federal medical assistance percentage (FMAP) rate declines, thereby requiring the state's matching rate to increase. This situation is expected to occur during the 2009 biennium.

State Fiscal Outlook Economic Overview

Employment and wage indicators continue to support stronger growth in the near-term, with the prospect of more moderate growth from calendar 2007 to 2009. While capital gains income rebounded in calendar 2004 and 2005, net capital gain realizations are expected to remain stable during calendar 2007, 2008, and 2009.

During calendar 2001, the Federal Reserve Board (FED) reduced interest rates 12 times in an attempt to stimulate the US economy. As the economy began to regain strength in calendar 2004, the FRB began increasing rates to insure stable growth with the goal of maintaining low inflation. Most economists project interest rates to stabilize during the 2009 biennium at close to historical averages. Short-term rates are expected to be about 4.5 percent, while long-term rates are expected to be close to 5.5 percent. The effects of higher interest rates may have some dampening impacts on economic growth to the benefit of increased state revenues from investments.

Even though interest rates have increased from historic lows, corporate profits are expected to increase significantly during calendar 2006 and increase only modestly thereafter. Property values continued an upward trend in 2006, and that trend is expected to continue through the 2009 biennium. Net taxable value growth in tax year 2006 (FY 2007), however, is expected to be near 5.7 percent as business equipment property growth is expected to be unusually high.

After decades of reductions in oil production – from a peak in 1973 of 34 million barrels to a trough in 1999 of 15 million barrels – recent Montana production has increased. With higher prices, new drilling activity increased 75 percent in 2003, and has increased nearly the same amount in 2004. In calendar 2005, production was over 32 million barrels and will probably be near 35 million barrels in calendar 2006. Higher production is expected to continue through calendar 2007 and then begin to decline in subsequent years.

Natural gas production in Montana doubled between 1981 and 2003 due to higher market prices, from 40 million cubic feet (MCF) to 80 million MCF, with 75 percent of that increase since 1997. Newly drilled wells have contributed about 20 percent to total production since calendar 2000. As with the oil market, new drilling activity was up substantially in calendar 2003 and 2004. Higher production is expected to continue through calendar 2007 and then begin to decline in subsequent years.

In summary, the economic outlook for the state is for strong to moderate growth throughout the forecast period. This general outlook for Montana's economy is supported by testimony received on November 15, 2006. The Revenue and Transportation Interim Committee set aside part of a scheduled meeting to hear from Dr. Paul Polzin, Bureau of Business and Economic Research. Dr. Polzin provided the committee with his positive outlook on various aspects of the state and national economies.



STATE FISCAL PICTURE

INTRODUCTION/SCOPE

The previous section described the economic outlook for Montana from the perspective of how economic activity at the state, national, and world level impacts state revenues and disbursements. This section describes in more detail how those economic conditions affect the state fiscal outlook and ultimately the size of the 2009 biennium budget.

GENERAL FUND REVENUE IMPLICATIONS

Montana's fiscal outlook for revenue growth is expected to be healthy but not nearly at the level observed during fiscal years 2004, 2005, and 2006. The preliminary revenue estimates adopted by the Revenue and Transportation Interim Committee (RTIC) shown in the revenue estimating resolution (HJ2) are based on strong economic growth through calendar 2006 with more moderate growth for

calendar 2007, 2008, and 2009. Figure 1 shows the comparative change by major revenue category, for an average increase of 5.8 percent over the 2007 biennium. For a complete discussion of general fund revenue forecasts by category, see the detailed explanation for each revenue component in <u>Volume 2 - Revenue Estimates</u>.

The key economic assumptions targeted as most affecting state government receipts are Montana total income (all sources reported as individual income tax income), employment and population levels, inflation rates, corporate profits, property values, interest rates, and energy prices. As discussed in the previous section, "Economic

| Figure 1 | | | | | | | |
|-------------------------|-----------------------------|-----------|---------|--|--|--|--|
| General Fund Revenue | | | | | | | |
| By Major Category | | | | | | | |
| | 2007 Biennium 2009 Biennium | | | | | | |
| | Estimate | Estimate | Percent | | | | |
| Major Category | Millions | Millions | Change | | | | |
| Individual Income Tax | 1,562.769 | 1,648.146 | 5.46% | | | | |
| Corporation Income Tax | 314.732 | 328.568 | 4.40% | | | | |
| Vehicle Tax | 230.378 | 239.268 | 3.86% | | | | |
| Investment Earnings | 107.178 | 102.772 | -4.11% | | | | |
| Natural Resource Taxes | 214.289 | 240.794 | 12.37% | | | | |
| Property Tax & Non Levy | 366.921 | 404.918 | 10.36% | | | | |
| Insurance Tax | 119.036 | 126.200 | 6.02% | | | | |
| Consumption Tax | 263.003 | 281.836 | 7.16% | | | | |
| All Other Revenue | 292.213 | 300.471 | 2.83% | | | | |
| Total General Fund | 3,470.521 | 3,672.973 | 5.83% | | | | |

Overview", the outlook for the majority of these targeted assumptions is positive for Montana's economy. The impacts of the current economic situation are reflected in the assumptions that were used to derive the revenue estimates and key factors are briefly highlighted below. A detailed explanation for each revenue component is in Volume 2 - Revenue Estimates.

Wage and salary income provides the largest portion of total income reported on state tax returns. On average, wage and salary income contributes about 65 percent of total income. Average growth has been 5.7 percent from calendar 1990 to 2005. For calendar 2007, growth is expected to be 9.5 percent, declining to 4.9 percent in calendar 2006, 4.0 percent in 2008, and 4.3 percent in 2009. State Fiscal Outlook State Fiscal Picture

Capital gains income increased sharply in relative to proportion of total income during the 1990s, growing from 4.2 percent to 9.2 percent of total income. Because of "9/11" and the effects of an economic recession, capital gains income plummeted during calendar 2001, 2002, and 2003. By calendar 2004, capital gains income began a rebound but is projected to remain stable at calendar 2005 levels through calendar 2009.

- Average annual growth in employment between 1990 and 2005 has been 2.4 percent, although since 2000 the average rate of growth has been 1.7 percent. It is expected that employment growth through 2006 will be 2.0 percent and decline to 1.6 percent in calendar 2006. Growth is expected to slow further in 2008 and 2009 to 1.4 and 1.2 percent, respectively.
- Population growth since the early 1990s has been positive, varying between 0.1 percent in 1998 to 2.3 percent in 2000. Growth through the next biennium is estimated at 0.7 percent annually.
 Population growth has an impact on revenues from consumption and individual income taxes.
- Since 1990, inflation has averaged 2.7 percent annually and is estimated at 2.3 percent through calendar 2009.
- o Between 1990 and 1997, U.S. corporation tax profits increased an average 10.3 percent per year, but have decreased an average 3.0 percent annually from 1997 through 2001, the greatest decrease of -8.5 percent occurring in 2001. In 2004 and 2005, corporate profitability increased by 26.0 percent and 32.7 percent respectively. That trend is not expected to continue, with projected annual increases of approximately 1.7 percent between 2007 and 2009
- o Property tax values increased slowly in the 1990s but fell in fiscal 2000 and 2001, primarily due to legislative changes that reduced the tax rate for business equipment property. Property values resumed an upward trend in 2002 and have increased every year since that time. That trend is expected to continue through the next biennium with an average annual growth of about 3.9 percent.
- Interest rates declined dramatically beginning in January 2001 to an unprecedented low in 2004. However, as the economy started to regain strength in 2004, and the Federal Reserve began increasing the discount rate. Short-term interest rates are expected to remain stable during the 2009 biennium. Long-term rates are expected to increase slightly through the 2009 biennium.
- As discussed in the previous section, high energy prices, especially for oil and natural gas, are expected to result in substantially increased production levels from these commodities in Montana. Oil production was over 32 million barrels in 2005, and is expected to be near 35 million barrels in 2006. Production is expected to peak in 2007, just over 38 million barrels and then decline to 36 million and 32 million barrels in calendar 2008 and 2009, respectively. Natural gas production was 80 million cubic feet (MCF) in 2003, and is expected to be 107 million MCF in 2006, 107 million MCF in 2007, 104 million MCF in 2008, and 100 million in calendar 2009.

GENERAL FUND DISBURSEMENT IMPLICATIONS

Montana's disbursement growth, like revenue growth, is responsive to economic and demographic conditions. While income levels, commodity prices, and interest rates influence revenue collections significantly, disbursement levels are more susceptible to population trends and demographic characteristics. Inflation rates also impact disbursement amounts, but are not a good overall measure of disbursement trends.

State Fiscal Outlook State Fiscal Picture

As happens to every consumer, the price government pays for goods and services increases because of price adjustments. Although state government does not purchase the same mix of goods that consumers do, the price of the goods they do purchase will increase in response to adjustments for inflation. Correctional services are a good example of a state operation that experiences high inflationary impacts relative to food and medical service purchases.

Over 20 percent of general fund expenditures are labor costs. Historically, the legislature has attempted to adjust employee compensation upward by an amount that recognizes the effect inflation has on an employee's take-home pay. The Executive Budget proposes to increase employee pay by 3 percent each year of the biennium to compensate for these inflationary impacts.

Finally, over 60 percent of general fund expenditures are educational support costs and direct human service benefits. For both of these types of services, inflationary increases can be substantial. Educational costs are directly tied to an increase in employee compensation, while human service benefits are heavily influenced by the cost of medical services.

As discussed previously, total population growth trends have been somewhat erratic varying from almost no growth to over 2 percent in 2000, with growth rates expected to be about 0.7 percent per year throughout the next biennium. Even at this modest rate, the demand for state services continues to increase. Depending on the demographics (age, income, etc.) of the population base, the demands for government services are a direct result of increased school enrollments, human service caseloads, and government employee workloads. With a shift in average age, school populations have declined while human services and corrections populations have grown. "Baby boomers" will continue to place increased pressures on government social programs as they enter retirement age.

The executive budget recommendation reflects a steep demand for government services due to a myriad of reasons. The executive requests a \$471 million general fund increase over the FY 2006 biennium base just to continue existing state services. Significant increases are targeted to human service, education, and public safety services, which represent nearly 85 percent of all general fund spending. In total, the executive budget requests a \$660.4 million (26.1 percent) increase in general fund authority over the FY 2006 biennium base.

GENERAL FUND ECONOMIC IMPLICATIONS – SUMMARY

In summary, revenue growth is expected to be moderate through the 2009 biennium, and when coupled with a large beginning general fund balance, the 2007 Legislature faces an unprecedented fund balance as it begins to prioritize state spending. Montana experienced the economic recession of the early 2000s but not nearly as severely as the rest of the nation. Although state revenues dropped off sharply during this time, revenue collections recovered in FY 2004, FY 2005, and FY 2006.

The cost of governmental services will continue to increase, even with a moderate rate of inflation and a slow growth rate in total population. School enrollments are declining, yet costs to support public schools continue to increase, especially in view of the recent court decision that determined that schools were under-funded. Human services costs will continue to escalate because of greater caseload demands, higher medical costs, and an increase in the state Medicaid match rate resulting from to due improved per capita incomes. Corrections population growth projections also suggest significant expenditure growth pressures.

State Fiscal Outlook State Fiscal Picture

While the 60th Legislature will face a bright financial picture, there are significant challenges and issues that need to be addressed. Unfunded retirement liabilities, school funding, health care costs, maintenance of state facilities, and correctional system populations are just a few of the major issues that need to be resolved. Furthermore, there is always uncertainty surrounding the price of oil and the impact the natural resource industry has on the economy in Montana. A sharp drop in the price of oil could significantly reduce revenues from oil production taxes, corporation income taxes, and individual income taxes. In addition, the long-term stability of the general fund is cloudy, as discussed beginning on page 186 of this volume.

What are the major fiscal challenges facing the 2009 Legislature? What are the Executive solutions? What are the significant issues identified by the LFD analysis?



MAJOR FISCAL CHALLENGES / SOLUTIONS / ISSUES

The state's fiscal picture continues to be bright as continued economic growth spurs increasing revenue, resulting in a large projected general fund balance for the current biennium and expected continuing growth in the next biennium. The downside is the uncertainty of how long it will continue, how much of the revenue is sustainable, and how much of the fund balance represents "one-time" revenues. One-time revenues translate into limits on how such money should be spent, and suggest that one-time revenues should not be spent for on-going program enhancements, but rather for spending priorities that would be one-time in nature as well. There are various spending and tax refund/rebate proposals being offered, evidence that the 2007 Legislature will have plenty of choices and plenty of policy decisions to debate.

The upcoming legislature will continue to face many fiscal challenges in their deliberations. To put the economic and fiscal picture presented in prior sections in perspective, the following summarizes key challenges and uncertainties that the legislature will have to consider in formulating the 2009 biennium spending plan and related fiscal policy. Below each is a summary of the executive proposed solution and issues identified by the LFD analysis where appropriate.

Fiscal Challenge

Funding for schools remains a significant fiscal challenge in spite of the work done during the interim by the Quality Schools Interim Committee and the funding provided in the December 2005 Special Session. These activities and actions were a response to a

district court decision in April 2004 (upheld by the Montana Supreme Court in November 2004) finding that state funding for K-12 education is not adequate and that the current funding methodology is unconstitutional. The coalition that brought the suit has commissioned a study to again determine whether funding is adequate. The results of the study are expected to be available by the beginning of the 2007 session and there could be pressure for more school funding over and above inflationary increases. In addition, although school enrollment has been declining for several years, there is evidence that the trend is reversing as projections show slight increases at the elementary level beginning in the current year and the number of births has been increasing for the past 5 years.

Executive Proposal: The executive budget provides nearly \$212 million in additional general fund funding over the FY 2006 base to the Office of Public Instruction. The most significant of the increases are \$72 million to fund components of 2005 special session funding not included in the FY 2006 base, \$40 million for K-12 BASE aid adjustments, nearly \$37 million to replace reduced guarantee funds, \$25 million for a full-time kindergarten initiative, and \$20 million to increase funding for the Quality Per Educator Component created in the 2005 special session.

Issue: The adequacy studies commissioned by the Quality Schools Interim Committee, and conducted by R.C. Wood and Associates contained a broad range of additional funding requirements for Montana K-12 education. Depending on the method utilized, Montana would need to add between \$0 and \$200 million per year in order to attain adequacy in funding K-12. Another study produced by the plaintiffs will not increase the certainty regarding which number is correct. It is not clear that any study could produce a "correct" number. When studies produce a large range of estimated resources to adequately fund K-12, many economists and policymakers are in a quandary regarding the true number.

The plaintiffs have stated that they will seek a show cause hearing at the conclusion of the 2007 legislative session in which they will ask the district court to rule on whether legislative actions to date satisfy the district court's ruling that the legislature provide adequate funding for K-12.

Fiscal Challenge

Health care costs make up a large share of total state and local government expenditures. A 2005 report by the Milbank Memorial Fund and the National Association of State Budget Officers showed that Montana state government health care

expenditures for FY 2003 were nearly 26 percent of total state expenditures (all funds). Besides the obvious spending categories of Medicaid and CHIP, health care costs are a component of state employee costs, corrections costs, higher education costs, and distributions to local governments and schools. With growth of medical and prescription drug costs well ahead of normal inflation, there is no relief in sight. This trend is accompanied by other trends: 1) a growing number of uninsured, and 2) increased complexity in the way health care is provided due to advances in treatment, including advances in technology, that make it possible to treat patients that may not have had treatment options before. Growing state costs are fueled to some degree by an aging population with growing demands for services and reductions in the federal Medicaid rate. Underestimating costs could result in a budget-breaking supplemental request or further reductions in health care services.

Executive Proposal: Compared to the 2007 biennium, the executive budget adds:

- \$233.8 million total funds, including \$77.1 million general fund for Medicaid eligibility and service increases, annualization of 2007 biennium initiatives, a reduction in the federal Medicaid match rate, and some 2009 biennium expansions, including provider rate increases
- An estimated \$15.7 million general fund for increased contributions to the state employee group benefit health plan
- \$23.8 million total funds, including \$18.1 million general fund, for medical institutions administered by the Department of Public Health and Human Services (DPHHS), including a new 120 bed program for mentally ill forensic patients
- \$15.3 million tobacco tax state special revenue for Big Sky Rx and \$9.5 million for Insure Montana, both initiated by the 2005 Legislature in response to passage of voter Initiative 149, which raised tobacco taxes and provided that funds be spent on health care related projects
- \$7.7 million total funds for CHIP, including a reduction of \$1.3 million general fund, which was shifted to tobacco state special revenue

Issue: The challenges surrounding health care costs are always enormous and frequently debated. It is an issue that is high on the list of policy discussions at every level of government and throughout the private sector, whether it is a discussion of how to improve access to health care, how to control

prescription drug costs, how to structure employee benefit plans, or how to keep citizens, employees, and families healthy and productive. Legislative consideration, of the issues and programs that relate in any way to the cost of health care, is a small piece of the overall debate. Controlling health care costs will require a larger, more encompassing, solution that has yet to be determined. The executive and legislature can seemingly only chip away at health care issues until that larger solution is found.

Fiscal Challenge

Correctional offender population continues to grow. From FY 2000 through FY 2006, the number of offenders in secure custody, community placement, and under community supervision increased from 8,854 to 11,718, an average annual growth of 4.8 percent.

The Department of Corrections projects that all segments of the correctional system will grow in the 2009 biennium, with overall population increasing from 11,718 in FY 2006 to 14,381 in FY 2009, or 6.7 percent per year in FY 2008 and 2009. Controlling expenditures in this area of the budget requires legislators to look at sentencing criteria, how court actions and alternatives impact the population, how to prevent individuals from entering the correctional system or returning to the system, as well as the costs and benefits of various treatment and incarceration alternatives.

Executive Proposal: General fund expenditures for the 2009 biennium increase \$100 million or 41.7 percent, when compared to the 2007 biennium. General fund increases include: \$59.7 million due to population growth including annualization of programs implemented or to be implemented in the 2007 biennium, expansion of programs, contract beds and increased probation and parole officers due to projected population growth, and a new prerelease center; \$27.0 million for a projected supplemental appropriation for costs that will be on-going; and \$10.0 million for operations of the Montana State Prison and a request for information technology projects.

Issue: The executive budget continues to emphasize community alternatives. It also includes funding for increased contract beds. However, the executive budget does not, in some cases, specify where additional facilities or beds will be located or who potential contract service providers might be. Additionally, two proposals for bed capacity expansion, the Secure Treatment and Examination Program on the Warm Springs campus and expansion of the work dorm at Montana State Prison are included in the long-range building proposal and/or Department of Public Health and Human Services budget request, but are not discussed in the executive request for the Department of Corrections.

Fiscal Challenge

Higher education has been funded to a greater and greater extent in recent biennia with increased tuition charges to students, as general fund has become a smaller share of total funding. The legislature will need to reconcile the difference between what the total

state funded share of higher education should be, and what the state can afford. In addition, the legislature needs to determine how to make the accountability measures (developed by the Postsecondary Education Policy and Budget Subcommittee (PEPB)) operational with the university system budget.

Executive Proposal: The primary initiative in the proposed executive budget is the College Affordability Plan, or CAP. The CAP includes \$25.6 million general fund for what the executive defines as present law adjustments at the university campuses, with the stated objective to cap tuition for resident students at their current FY 2007 level.

Issue: Given the split constitutional authority between the Board of Regents and the legislature, the CAP proposal by the executive would not be binding upon the university system specific to resident student tuition rates. At best, the CAP is a proposed agreement that would not have the force of law.

Fiscal Challenge

State employee pay and benefits are likely to be a topic of debate for the 2007 session. State employees received a 3.5 percent increase in FY 2006 and a 4.0 percent increase in FY 2007, following a minimal increase in the previous biennium. State

contributions to employee health insurance benefits attempt to keep pace with the growth in those costs, costs that continue to climb. Personal services costs are a large portion of the funding of state government and proposed increases warrant some scrutiny. At the same time, state government must be able to offer competitive compensation in order to recruit and retain a qualified workforce.

Executive Proposal: The Governor's budget includes a 3 percent per year increase in state employee salaries (provided as of October of each year), and adjustments to the state share of health insurance cost of \$396 and \$432 in calendar years 2008 and 2009, respectively. The executive proposal also includes a "flexibility component" (0.6 percent) intended to allow agencies to provide salary adjustments for such things as progression, competencies, and performance, and an increased longevity increment (1.5 percent to 2 percent) for employees that have worked 10 years. In addition, the proposal provides for making the already partially implemented "broadband pay system" the state's primary compensation system. The estimated cost of the proposal, which would be presented to the legislature in HB 13, is \$58.6 million general fund and \$42.2 million other funds over the biennium.

Issue: The legislature has sanctioned, and the Governor has mandated conversion to, an alternative pay plan that provides more flexibility to managers on salary levels and changes in salary for such factors as market progression, merit, and competency. One of the primary goals of this conversion is to improve recruitment and retention of employees. Generally, changes in salary for these purposes have taken place outside of the pay plans reviewed and approved by the legislature, and are built into statewide present law adjustments. Consequently, these changes are not transparent to the legislature, and the legislatively reviewed pay plan becomes a smaller part of the factors that cause adjustments in salaries. The Governor's pay plan proposal exacerbates this issue. The legislature may want to review any proposed pay plan within that context, and provide more guidance on the implementation of the alternative pay plan, including establishing measures for gauging success in addressing recruitment and retention.

Fiscal Challenge

The financial condition of **public employee retirement funds** remains a significant issue among the challenges facing the legislature. The state constitution requires that public retirement funds be actuarially sound and state law provides that contributions to the

plans be sufficient enough to amortize the unfunded actuarial accrued liability (UAAL) over 30 years. The investment losses of the 2001-2002 recession accompanied by the approval of unfunded benefit enhancements, have yet to be recovered in full. In spite of an infusion of \$125 million by the legislature and some changes in investment strategies intended to at least stabilize investment returns, four of the public pension plans still have UAAL's that cannot be amortized over a 30-year period. The picture has improved, but the total unfunded liability of the four plans is reported at \$1.3 billion, of which \$581 million is needed to satisfy the amortization requirement.

Executive Proposal: The executive budget proposes: 1) A \$100 million cash infusion to the Teachers' Retirement System (TRS); 2) phasing in higher employer contribution rates for TRS, funded by state funds to avoid property tax increases; 3) closing loopholes in the TRS benefits calculations; 4) reducing the guaranteed annual benefit adjustment for new hires in plans under the Public Employees Retirement Board umbrella from 3 percent to 1.5 percent; and 5) increasing employer contribution rates for the Public Employees' Retirement System (PERS) and the Sheriffs' Retirement System (SRS) to actuarially fund the remaining liability down to being amortized within the 30 year period. These actions are designed to make all of the plans actuarially sound relative to the most recent actuarial valuation.

Issue: The executive solution appears to resolve the issue, but there are long-term on-going costs that will become part of the base budget for many years to come. An alternative proposal for PERS, SRS and the Game Wardens' and Peace Officers' plans would also increase employer rates and state and local obligations for a long period of time. Regardless of the solution chosen, retirement boards, plan administrators, and legislators will need to be vigilant in maintaining the soundness of these plans. The health of these various plans will continue to be a challenge in light of the volatility of investments and the changing demographics that make up the actuarial assumptions.



Management of capital assets is an important function of state government. A key component is the **maintenance of state facilities** and other assets. The deferral of such maintenance has been a long-standing issue, made worse by the budget shortfalls

of recent years. Delaying maintenance activities can result in higher future costs as facilities deteriorate beyond the need for ordinary repairs and replacements.

Executive Proposal: In the 2009 biennium, the executive recommendation proposes a greater commitment to state building maintenance and construction by including one-time general fund transfers (OTO) of \$101.8 million to the capital projects account. With OTO funds, the executive addresses the need for deferred maintenance in the state complex. In this proposal, the deferred maintenance backlog, estimated at over \$240 million, would be reduced by approximately \$66.5 million. Additionally, the executive recommendation includes an on-going transfer of \$7.2 million per year to increase the funds available for major building maintenance. This increase in funding would reduce the growth of the deferred maintenance backlog by providing more adequate funding for the upkeep of state buildings. In short, both measures would serve to reduce the stresses on the LRBP and the state major maintenance program.

Issue: The issue of the major maintenance funding inadequacy and the growing deferred maintenance backlog has generated the concern of both the executive and the legislature, and both have developed ideas on how best to attack the problem. The interim Legislative Finance Committee agreed, after committing time and research to the issue through an interim subcommittee, to sponsor a bill that would develop a new method of funding the LRBP, through a major maintenance funding surcharge. The rental surcharge proposal would eliminate all current funding streams into the LRBP and require the program to pay the debt service on four bond issues. The net/new cost of the proposal is estimated to be \$24.8 million in the first biennium.

The members of the 60th Legislature will be asked to consider the attributes of each plan and determine the best way to fund the LRBP in the future.



Legislation known as the Montana Public Defender Act (SB 146), enacted by the 2005 Legislature, created a **statewide public defender system**. This new statewide system became operational beginning July 1, 2006 (FY 2007). The new system is charged with

providing public defender services in all courts in this state and is administered by the Office of Public Defender (OPD). This new function has reported funding shortfalls for FY 2007 and is expected to request a supplemental appropriation of about \$3.3 million.

Executive Proposal: The executive requests \$38.4 million for the 2009 biennium for on-going support for the new system, which is more than \$10 million greater than the \$27 million estimated ongoing costs of the new system projected by the Law and Justice Interim Committee in its study report of the system. The new public defender system provides services largely through the use of state employees rather than contractors. In general, state employees provide services in more populated geographic areas of the state while contracted attorneys provide services in less populated areas of the state.

Issue: 2009 biennium funding of about \$19.2 million per year is significantly greater that the \$14.1 million appropriated by the legislature for FY 2007, the first year of operation for the new system. Lack of detailed data supporting estimates, historical expenditure patterns, and caseload data make it difficult to determine what factors are driving costs and thus, what level of funding is necessary to support the system the legislature envisioned. This lack of data also makes it difficult to identify potential policy decisions or changes to this new system that the legislature might find desirable.



Pending litigation and subsequent court rulings can impact state finances. The school finance litigation lawsuit outcomes are still under scrutiny. Currently, there are three lawsuits related to workers' compensation claims that could have significant general fund

consequences. Another lawsuit is challenging requirements for dam owner to make lease payments on navigable stretches of Montana rivers. And finally, there is a suit protesting state property taxes of a state power company.

Executive Proposal: The executive budget does not mention the K-12 lawsuit, nor does it address the others listed above.

Issue: The legislature simply needs to be aware of the potential cost or revenue implications of the array of litigation in which the state is a party. While the outcomes are unknown at this time, each of these lawsuits has the potential of significant impact to state revenues or expenditures.



Supplemental emergency appropriations for the next biennium have not in the past been budgeted by the legislature and not accounted for in the ending fund balance. The state continues to experience supplemental appropriations each biennium, particularly

for fire suppression. The state share of fire costs for FY 2006 surpassed \$36 million. For any future biennium, the legislature needs to keep in mind that supplemental appropriation requests are common, with general fund supplemental appropriations varying from \$11.5 million to \$82.2 million over the previous 10 biennia.

Executive Proposal: The executive budget includes general fund supplemental appropriation requests totaling \$76.4 million for FY 2007 (see page 121). Supplemental appropriations for the 2007 biennium will be addressed in HB 3 and HB 10 of the 2007 session. In a related area, the executive budget includes a \$5.0 million per year appropriation in the Department of Natural Resources for fire suppression. This is in addition to the \$16 million general fund emergency statutory appropriation that is already in law and is requested to increase to a maximum \$25 million. The executive has, for the first time, included the \$16 million general fund emergency statutory appropriation in its general fund status sheet, recognizing the likelihood that this type of expenditure will occur and should be accounted for in the fund balance.

Issue: Typically, the potential for supplemental appropriations is considered a component of the fund balance reserve, but has not been specifically identified in the balance sheet. This speaks to the need for an adequate reserve, which is discussed later. By including it in the balance sheet for the executive budget, the administration is recognizing the potential cost separate from the fund balance reserve. The legislature needs to consider changing its practice of not including an allowance for wildfire costs in particular.



Potential **loss of federal funds** as a source of funding for many state and federal programs is a concern because of the large federal deficit and the administration's goal of cutting the deficit in half by 2008. The loss of federal funds translates to either

reductions in services to citizens or increased state costs to offset the loss, loss of jobs in the state, and loss of "imported" money into the Montana economy.

Executive Proposal: The executive budget includes \$3.4 billion in federal funds for the 2009 biennium, a \$229.6 million, 7.4 percent increase over the 2007 biennium (actual 2006 and budgeted 2007). This includes some replacement of federal funds with general fund.

Issue: The Montana budget has an increasing reliance on federal funds, as federal funds comprise 43.1 percent of the total proposed HB 2 budget. A significant federal cutback could have a devastating impact on government services in Montana and/or the state budget.

Fiscal Challenge Long-term stability of the general fund becomes an issue when changing demographics become a big player in the demand for government services or are an influencing factor in the generation of state revenue. Emerging examples of potential

instability are: 1) the aging population of Montana as well as other states; 2) the tenuous nature of components of some key revenue sources; 3) the pending litigation mentioned above; and 4) the federal funds reliance issue discussed above.

Executive Proposal: The executive budget, for the most part, deals with the upcoming biennium budget (2009 biennium) and does not address the revenues and expenditures beyond those years, beyond the short-term calculation of structural balance. The executive budget does, however, flag a large number and amount of expenditures in this budget as one-time-only, meaning that they will be removed from the base for the 2011 biennium budget. In addition, the executive recommends a \$100 million ending fund balance reserve and the establishment of a "Big Sky Savings Account" as a buffer for future uncertainty and long-term instability (legislation to establish a budget stabilization account is being introduced in concert with the Legislative Finance Committee which had developed a similar concept).

Issue: The legislature needs to be aware of potential future impacts as it considers the many proposals it will face in the upcoming session. An in-depth assessment of the long-term sustainability of the general fund may be a prudent consideration.



Economic development is a high priority of the administration. At various time over the years, legislatures have invested in numerous economic development efforts but have historically had difficulty seeing results, as results are frequently difficult to measure. The

challenge for the legislature is to make the funding of economic development agencies and programs contingent on agencies providing measurable goals and objectives for such efforts and being able to document the outcomes and prove the value of the investment.

Executive Proposal: The executive budget continues a number of economic development programs that were funded by the 2005 Legislature as one-time-only appropriations. It continues the new worker training program, with funding increased from \$2.8 million to \$8.0 million. It continues funding for the made in Montana Program, switches the funding for the Main Street program to the general fund, continues the Tribal Economic Development program with increased funding, funds the Montana Capital Investment Board which was created but not funded by the 2005 Legislature, and provides \$2.0 million for grant funding to support biomedical research in Montana. It also increases funding for the Governor's Marketing Montana and Business Recruitment program by \$400,000 over its original \$600,000 appropriated by the 2005 Legislature.

Issue: As is true for many economic development efforts, there needs to be accountability for the investment that is committed to a project. Measurable goals and objectives, and related accountability measures, are critical in determining the effectiveness of these efforts.



Controlled budget growth (structural balance) will continue to be a concern, regardless of the sizable projected fund balance expected for the end of the 2007 biennium, with more moderate revenue growth anticipated through the 2009 biennium. The challenge

for the legislature is to resist the temptation of spending a large fund balance on on-going obligations and to not spend more in a biennium on on-going programs than is available from on-going revenues. A fund balance, in excess of projected revenues and a prudent reserve, should be considered one-time revenue just by its very nature of being unexpected revenues.

Executive Proposal: The executive budget is structurally balanced and, as analyzed, meets the challenge presented above. The longer term issue of sustainability is raised in a previous challenge.

Issue: There will be plenty of temptations to spend moneys on on-going programs. The legislature needs to keep the bigger fiscal picture in mind as it considers the various proposals.



Adequacy of the **ending fund balance reserve** will need to be monitored by the legislature as the session progresses. What will it take to ensure that Montana keeps an adequate "safety net" in place?

Executive Proposal: The executive budget includes a \$241 million projected fund balance at the end of the 2009 biennium, but recommends that the legislature leave at least an \$100 million ending fund balance when a final budget is passed. The executive proposal discusses a "Big Sky Savings Account" as a set-aside of some of the fund balance for the future.

Issue: While the available funds are well above the recommended minimum fund balance, other spending demands will likely compete for a share of this balance. National experts consider a 3 percent reserve to be a minimum (about \$100 million). The legislature should be looking at retaining at least that amount as a safety net. In addition, Montana is one of only a few states without a rainy day fund and may also want to consider setting up and placing seed money in a "rainy day fund", as is being proposed by a bill jointly offered by the Legislative Finance Committee and the administration.

Fiscal Challenge

Economic uncertainties can undermine revenue-forecasting efforts, and contribute to an increased demand for government services in areas such as human services and corrections. As in any legislative session, there are many unknowns surrounding

revenue forecasts. Capital gains income, corporate profitability, and oil and gas price and production could all fluctuate significantly. Assumptions used in the revenue forecasting process are based upon the best information available, but what might happen to change those assumptions?

Executive Proposal: The executive proposals attempts to address the challenge by recommending an adequate fund balance reserve (\$100 million) and the creation of the "Big Sky Savings Account", a set-aside of funds for future revenue shortfalls or unexpected expenditures. The vehicle for the latter is legislation approved by the Legislative Finance Committee (on which the executive agreed to be a corequestor), providing for a "budget stabilization account".

Issue: If the legislature chooses to enact legislation creating the budget stabilization account, it may want to make sure that a sufficient balance is established to provide the buffer needed to encounter future events, or at least a level of funding that will help mitigate a severe revenue shortfall such as occurred in FY 2002 and FY 2003.



General fund spending without HB 2 appropriations occurs in general fund non-budget transfers and through statutory appropriations. Authority for such spending is authorized in statute, but doesn't receive the usual scrutiny that HB 2 appropriations

require. The challenge in this case is for the legislature to minimize the occurrence of spending that does not require regular scrutiny by the legislature.

Executive Proposal: The executive budget does not address this issue.

Issue: The legislature has established numerous statutory appropriations and transfers in statute, expenditures that do not receive the same scrutiny or prioritization as HB 2 appropriations. Statutory appropriations for the 2009 biennium are estimated to be \$297.6 million general fund and transfers are estimated to be \$18.4 million.